Private equity firms have long realised that superior value creation is all about the active management of portfolio companies and that this active management is one of the only tools within their control to generate higher returns.

Studies have shown that private equity firms actively engaging in the management of portfolio companies deliver returns that could be as high as double those produced by other managers who do not engage early on. These engrained characteristics of the business model make private equity more of a governance platform than a financing one: an entrepreneurial form of governance characterised by the alignment between management and owners. Yet, whilst most private equity managers in the Middle East region have rapidly developed their negotiation skills at the time of buying and selling of portfolio companies, few have explored the opportunities of creating substantial shareholder value via the proactive improvement of portfolio companies. The differentiating factor and the most formidable challenge they face, resides in the value creation process during the holding period.

This challenge in the Middle East does not relate to economic factors or financing issues, as much as it does to the deeply rooted social and cultural values. The evolution of regional businesses can be traced back to the development of the gulf economies as a result of the discovery and deployment of oil reserves. The majority of families, organized in tribal societies, operated as traders, until the late 1930s. Later on, the boom and subsequent accumulation of oil driven wealth brought about the need
for a more diversified economy: merchants ventured into the banking and construction sectors and then, building on these successful investments, into retail and services. Businesses operated in relatively closed economies with limited competition, relied on personal and socially influential networks, and benefited from capital abundance. This particular environment offered these businesses a dominant position, considerable power, and moreover confidence in the existing management principles which proved successful during that period.

Over this short history of modern capitalism, and despite numerous international joint ventures that had become common over time, the tribal values persisted and left their marks on how we are doing business in the region today:

(i) The “Chairman” corresponds to the historical “Tribal Chief” who is typically the principal founder. He still owns the bulk of the enterprise and still possesses the majority of the powers associated with the position of Chief Executive. The title “Chairman” is also easily interchangeable with other titles such as General Manager, President and even Managing Director.

(ii) The board of directors, the corporate evolution of the traditional Majlis, operated for a long period in an oral and consensus-based culture, where many did not realize the need to create and document policies and procedures to improve operational efficiencies and reduce future conflicts.

(iii) The disclosure adverse culture is another inheritance probably relating to the trade secret mentality. Most private sector wealth is held privately. The overall owners’ reluctance to publicise the operational and financial aspects of their enterprises, have led over time to a general acceptance of the lack of transparency. This has also contributed towards a fear of international Private Equity firms to venture into the Middle Eastern region.

(iv) There are a large number of traditional small to medium sized firms in the region where the chairman still signs the payroll, and if he happens to be travelling his staff’s salaries wait until his return for his signature on the cheques! Whilst this example of the lack of delegation may seem archaic in terms of a ‘Western’ governance model, Middle Eastern culture has always been slightly resistant to the delegation of authority. This has contributed towards operational bottlenecks and restrictive corporate practices. The resistance to relinquish control can make it difficult for private equity managers with a minority share to initiate the required changes effectively so as to steer the organisation towards its full potential.

In my opinion, what private equity managers should focus on to overcome these cultural hurdles, is to work with portfolio companies on four different fronts:

(i) Creating and implementing culturally effective corporate governance frameworks;

(ii) Effectively translating Corporate Strategy into Operational Execution;

(iii) Structuring “chaos” by optimising operational structures and infrastructure; and

(iv) Optimising and driving operational performance as a competitive tool to drive shareholders value.

All four dimensions are interlinked and should be addressed concurrently. Once the creation and implementation of a culturally sensitive yet effective corporate governance framework is captured, progress on the remaining three areas is easier to attain. First and foremost, instilling the change requires the courage of business owners to realise that corporate governance is in their own interest and accordingly make the necessary changes. They need to start realizing that:

1. Establishing a clear and documented segregation between the roles and responsibilities of Owners, Board Members, and Management will increase efficiencies and leave each one to do what he does or should do best

2. A more developed Board, with the right mix of skills, is crucial for the development and implementation of a winning strategy

3. An effective Authority Matrix will help delegate authority whilst creating the appropriate checks and balances and promote accountability

4. It is simply too risky to operate without an appropriate risk management policy and framework, however simple. Establishing an audit and risk committee is imperative for the growth and sustainability of any larger business

5. Increasing transparency will help pinpoint underlying issues that PE experts may be in a position to fix whilst providing the market with transparency confidence and data for any future valuation and exit from the investment

6. And that by relinquishing control within the right structure, owners will most probably end up with a smaller share of a bigger company

7. Corporate Governance is not a cost. It is an investment. Industry related corporate governance principles and Environment Social and Governance (ESG) best practices have proved to contribute to the value creation of portfolio companies.